Aaron Brown

But when I'm bad I'm better

Is reputational risk management just a euphemism for cowardice?

The reputational risk manager's week

In 1933, actress and screenwriter Mae West released her third movie, *I'm No Angel*, with the tagline "the story of a girl who lost her reputation — and never missed it." The slipperiness of the word "reputation" can be seen by noting it would have meant the same thing if Mae had written "the story of a girl who got a reputation— and enjoyed every minute of it."

I thought of Mae as I listened to Andrew Crockett of JPMorganChase talk about reputational risk management at the GARP annual convention last month. He specifically mentioned the damage to firms from the public demonstrations a few weeks prior, protesting funding of coal-fired electricity generating plants in Texas. I asked him if refusing to risk reputation didn't put a firm at the mercy of any group able to attract a few television cameras, after all, a person afraid to risk a reputation will never get one.

He answered, reasonably enough, that the time to consider reputation is before doing the deal, not after the protestors arrive. If a firm only undertakes business it can be proud of, "first class business in a first class way," it can be confident that its reputation will survive the occasional unpopular action. However, I'm still uncomfortable with the concept of reputational risk management, I can't help suspecting it's a euphemism for cowardice.

I'll get back to that point in a minute, but I want to add another connection. Andrew mentioned that of the twelve top investment banks in 1990, seven no longer exist as brand names (none of them liquidated completely, all were folded into other institutions, but any value to their once-good names is gone). While that statement is correct, it seems to conflict with a statement Philip Augar made in *The Greed Merchants*, that the top investment banks have maintained high profit margins and stable market shares over the last 25 years. Evercore banker Jonathan Knee, in his book *The Accidental Investment Banker*, takes a much more personal perspective and sees the issue from both sides. In this article I want to answer two questions: is reputation a suitable subject for risk management, and what should be the attitude of an investment banker toward reputation?

Violence, punctuated by commitee meetings

Let's start with a basic distinction. There are risks to be minimized and risks to be managed. If a football team is behind in the game, it should adopt strategies that increase volatility, because that increases its chance of winning. The team that's ahead should try to reduce volatility. This is risk management. The amount of risk is set to an optimal level to accomplish a goal. On the other hand, the risk of injury to a player should be minimized. That doesn't mean reduce the minimum possible, we should use a cost-benefit analysis. We don't want to ruin the game or make equipment prohibitively expensive. But we never want to raise the risk of injury for its own sake, as we sometimes want to raise the volatility of scoring.

Someone might try to manage the risk of injury. For example, the owners of football teams might want to keep the level of injuries at a moderate level to appeal to violence-loving fans and increase player turnover to reduce their ability to organize. The point is we consider it a bad thing when someone tries to manage a risk that should be minimized. People who minimize risks that should be managed are called "cowards."

If taking a "reputational risk" means doing something dishonorable, it is a risk that should be minimized. Someone who cares deeply about honor will pay high costs to keep it very low, someone who cares little about honor will pay only a little. One person will give her life for a small point of principle. Another will steal a nickel if there's small chance of getting caught. But only a perverse person will be dishonorable for no personal gain.

On the other hand, if risking reputation means doing something potentially unpopular, it is a risk to be managed. A fanatic will do whatever he thinks is right, regardless of popularity. But anyone who values peace and quiet, and more to the point anyone running a large company that requires cooperation of many diverse people, will ration unpopular actions. Too much unpopularity damages morale and causes fights, too little makes you irrelevant. It may be cynical for an individual to strive for an optimum level of unpopularity, low enough to have friends, high enough to have their respect. But it makes perfect sense for a company to track public reaction to its actions and worry if it generates either too much anger or too much praise. A portfolio manager doesn't want only stocks no one on earth would buy at any price, but she also doesn't want only the most widely-held stocks. To earn her fee, she must strike the right balance. As a shareholder, I want to see my CEO at work, not on the crime page or the society page of the newspaper.

The malfeasant seven?

If I understand Andrew's point, he defined taking a reputational risk as doing something dishonorable, and said it should be managed, and pointed to the seven vanishing investment banks as examples of bad reputational risk management. I disagree. It's true that some employees of the seven banks did things that were at least arguably illegal or immoral, but I don't think that's what brought the firms down. All seven were engaged in controversial financial innovation. As a group they were more innovative (and more reckless) than the five that survived. I think it was unpopularity that brought the scrutiny that led the indictments and regulatory penalties to snowball until the firm had to be sold and the names suppressed. That doesn't mean the charges weren't justified, some were, some weren't. But similar charges resulted in fines and short-lived bad press for the survivors. The difference isn't that the banks whose names perished were less honorable, it's that they brewed volatile cocktails of shady dealings with unpopular innovations, and were injured in the ensuing explosions. The other banks used more moderate quantities of the same ingredients, stored with better separation. They practiced better reputational risk management.

As a shareholder, I want to see my CEO at work, not on the crime page or the society page of the newspaper

How is Andrew's point that investment banks are falling as leaves in October consistent with Philip's that the top banks seem eternal? Modern investment banks have businesses other than investment banking, particularly sales, trading and asset management. There have been scandals in all four areas, but brand names matter only in investment banking and asset management. Any problem can cause the salespeople and traders to find new homes, there is no brand name to protect. But only a major scandal in investment banking can persuade an investment banker to change the name on her business card, and only a major scandal in asset management will cause the funds to be renamed (and many of them have names distinct from their corporate parents anyway).

Therefore while top investment banks have acquired and divested parents and children over the last quarter century, the top shops still operate under the same names, with the same enviable profit margins. Something similar could be said for asset management, except there are lower barriers to entry so the established brands have to share shelf space with newcomers. But there too, good brands are hard to kill, and very nice to own. It is the sales and trading organizations that become anonymous in a hurry.

The company you keep

While Andrew sees the problem as destruction of established institutions, Philip is worried about longer-term subtle danger. The association of investment banking with the other businesses creates not only more opportunity for scandal but also intractable conflicts of interest. Unless investment banks shed these businesses to concentrate on giving disinterested advice to corporate leaders, their high profit margins and open ethical conflicts will prove fatal.

Jonathan would probably agree with Philip to this extent. In fact, he voted with his feet, leaving Goldman Sachs for Morgan Stanley, then Morgan Stanley for Evercore (which does investment banking advisory work exclusively). But in his book he is less concerned than Philip with investment bankers getting corrupted by inappropriate associations, he blames the bankers themselves. Like Philip, he sees the social value and profit opportunity as advising CEO's. His scathing criticisms are aimed at both the management of investment banking and the many investment bankers who choose the field out of narcissism rather than dedication. To him the reputational risk is not popular scandal nor profiteering and conflict of interest, it is compromising the quality of the product because the wrong people are running the business the wrong way and hiring more wrong people to do the work.

If you agree with this view, it is a risk that should not be managed, but cannot be minimized, because the people who would minimize it are the problem. The only solutions are to revolt or emigrate.

In the end, I come down on the side that there is a legitimate need for reputational risk management. I respect the arguments of both Philip and Jonathan for the old-fashioned investment bank, but I think the way of the future is larger, more integrated institutions. Such institutions will have scandals and conflicts of interest, which they will have to prevent ballooning into disasters. At the same time, they will have to champion unpopular causes and do misunderstood business, those are prices for innovation and risk-taking. They have to be careful not to bite off too much risk at one time. I think finance has progressed irreversibly from a craft to a science, and the best corporate finance advice requires support from the best market knowledge, execution ability and buy-side perspective. These institutions will have to manage carefully to avoid being too unpopular to survive on one hand, and too concerned about popularity to do their jobs on the other. Mae West still said it best, "when I'm good, I'm very good, but when I'm bad, I'm better." W